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SBA

Business Basics

Evaluating Money Sources

A Self-Instructional Booklet
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KEEP THIS GUIDE SHEET -- FOR INSTRUCTOR'S USE ONLY

EVALUATING MONEY SOURCES
Instructor's Guide Sheet

This booklet contains:

1. Internal Capital Sources Over External Sources
2. Trade Credit and Suppliers
3. Debt and Equity Capital
   Advantages - Disadvantages
   Availability
4. Preparing Requests
5. Evaluation Factors -- Cost, Risk, Flexibility, Control, Availability
6. Internal Capital Generation -- Retained Earnings, Asset Management, Cost Control
7. Trade Credit Cost and Risk
8. Evaluation Financial Stability and Liquidity
9. Measures of Stability and Liquidity -- (Ratios)
10. Short and Long-term Debt Impact on Liquidity Indicators
11. Trading and Equity
12. Comparing Debt and Equity Capital

Supplementary Instruction
Assist a client, who has a foreseeable need for capital, perform:

1. Analysis of capital that can be generated from prudent asset management.

2. Analysis of capital that can be generated from earnings.

3. Analysis of additional capital that can be generated through closer cost control.

4. Evaluation of the business' liquidity and stability, through calculation of debt-equity, current, and acid test ratios, as well as, considering the effect of any proposed additional financing.

5. Prepare a plan for securing additional trade credit without jeopardizing the business/standing with key suppliers.

6. Prepare a "T-account" to compare debt and equity alternatives in terms of cost, risk, flexibility, control, and availability.

7. Develop a comprehensive plan to submit to potential lenders and investors that includes the following: Forecast of Capital requirements, Profit Plan, Marketing Plan, and Cash Flow Statement.

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INTRODUCTION

When is 10% less than 7% ? A ten percent interest charge can cost less than a seven percent interest charge if the time of the ten percent loan is shorter than the time for the seven percent loan. Financing is tricky and one of your most important decisions is to select the right source of financing. The source affects the future of your business and the likelihood for success in your financing efforts.

Selection

As you learned in an earlier module, there are several sources of money available to you. Frequently, the key decision is to determine which is most appropriate for your current needs. Selection of the right source to meet this need can often have a pronounced effect on the future of your business as well as the likelihood for success in your financing efforts.

The short-term bank loan, when a longer-term loan is required, can soon create a crisis. Selling a piece of the business to raise capital that could have been borrowed can be extremely costly. Over-extending trade creditors can be costly and restrictive.

There are many opportunities for mistakes in selection of the capital source. However, the right selection can provide you with the capital you need while freeing you from unnecessary costs, risks, or the possibility of losing control of your own business.

Booklet Objectives

This module has been designed to help you select the appropriate capital source to meet your needs. In this module, you will learn how to do the following:

- Use internal sources of capital to reduce or eliminate the need for external capital.
- Use trade credit so that your standing with suppliers is maintained and your costs are minimized.
- Analyze the advantages and disadvantages of the two major sources of external capital, loans and equity investments.
- Determine if and when a loan or equity investment is preferable.

- Combine debt and equity capital to increase the chances of securing the capital you need.

- Prepare your requests for capital to bankers or investors so that they will have the information they need to make a rational decision while impressing them with your ability as a business manager.

EVALUATION FACTORS

Five Primary Factors

To determine the most feasible source of raising needed capital in a particular situation, you should consider five primary factors. These are as follows:

- Cost. How will each source affect the earnings of the present owners?
- Risk. Which source exposes your business to the lowest degree of risk?
- Flexibility. Will conditions imposed by any source reduce your flexibility in seeking further capital or in using capital generated through operations according to your best judgment?
- Control. Could the present owners' control of the business be adversely affected? Could the loss of control prevent you from making operating decisions that you consider to be in the best interests of the business?
- Availability. Which sources are, in fact, available to your business?

Cost

The cost of a capital source is usually measured by its impact on the earnings of the present owners, not simply the increased expenses incurred by the business. To understand the significance of this distinction, consider a company that is deciding between a $20,000 loan at 10% interest or selling 25% of the shares in the business in order to raise $20,000. The business expects to pay interest on the loan of $2,000 per year, which would reduce the business' net income by $2,000 before taxes. If the business expects to earn $30,000, interest expense would reduce it to $28,000. In the equity alternative, the business' net income would be $30,000, since there would be no interest expense. However, only $22,500 would be applicable to the present owners since $7,500 ($30,000 x 25%) would represent the participation of new shareholders. Therefore, the business' income under the equity alternative would be higher, but the participation of the present owners would be less.

Each capital source has its own cost. Internal sources such as the sale or liquidation of assets could lead to loss of revenue following inventory disposal or added operating costs if machinery were sold to generate cash. Use of trade credit could cause discount forfeiture. In reaching a decision, it is important to consider all relevant costs for each source.

Risk

There are several types of risk involved in raising capital. Use of trade credit could lead to supplier dissatisfaction and possible damage to your credit standing.

Since borrowed money must be repaid with interest, debt capital imposes obligations upon the cash flow of the business that must be met on a specified schedule to avoid default. A default could cause a number of actions as specified in the note agreement, such as forfeiture of collateral or forced bankruptcy.

The only money source that involves no risk to the business is equity capital since the equity investor, not the business, is the risk-taker.

Flexibility

Total reliance upon asset management to meet capital needs could cause a business to be overly cautious in credit extensions or inventory purchases, leading to lost sales.

The use of trade credit as a major capital source can make a business overly dependent upon a few suppliers and unable to take advantage of better merchandise prices available from others.

Loans often carry stipulations that prevent the business from securing additional debt with a prior claim against assets. For example, a term loan agreement might prevent you from pledging receivables or inventories as collateral for additional borrowing.

Control

The use of internal financing and trade credit is unlikely to have any impact upon the control of the business exercised by present owners.

Equity investors are normally entitled to some degree of control in the company's operations. Shares issued to new investors normally carry voting rights in proportion to the number of shares held.

Lenders do not ordinarily participate in the affairs of the business, nor are they legally entitled to a vote in corporate matters, as are common shareholders. However, major loans from banks, insurance companies, or others may require that the lender be given some representation on the board of directors. This representation, usually taken only to protect the lender's interest in keeping abreast of corporate affairs, could affect the present owners' control of the business.

Availability

Frequently, a business may be restricted in its ability to raise capital by the lack of availability of preferred sources. Regardless of the source considered most feasible, the business only has access to whatever is available.

For example, a business may have retained all earnings and managed its assets prudently so that no significant additional capital can be raised internally. Trade credit may be exhausted and the company may be so burdened with interest and debt repayments that the only realistic alternative is equity, despite unfavorable cost and loss of control.

Weighing Evaluation Factors

Every capital source considered should be evaluated in terms of cost, risk, flexibility, control, and availability. Which of these is most important? Which is least important? The answer will depend upon the application of your judgment to the particular situation. In many cases, availability may be all-important. In others, cost may be the deciding factor. The decision can only be made by the owners' prudent judgment after assembling and analyzing all of the relevant facts.

NOTE: Cover the correct answers and write your answers on a separate piece of paper (or in the book). Check your answers and review weak areas. Do all the exercises the same way.

1. Identify the five factors that must be considered when evaluating any capital source:

   1.
   2.
   3.
   4.
   5.

READEX FICHE

cost
risk
flexibility
control
availability

---

2. When considering the cost of needed capital, cost must be measured from the standpoint of:

   a. the effect on the earnings of the business
   b. the effect on the earnings of the present owners

---

   b. the effect on the earnings of the present owners

---

3. Since equity capital involves no interest expense, the addition of equity capital would not affect the net income of the business. Therefore, it should be considered a "no cost" financing alternative. (TRUE/FALSE)

   FALSE (Since equity financing requires that present owners share the earnings of the business with others, it involves a cost to the present owners.)

---

4. What costs might be incurred in generating capital internally through disposing of inventories?

   Inventories may be sold at a loss or inventories needed for sale to customers may not be available.

---

5. What cost would be associated with the use of trade credit to raise needed capital?

Cash discounts may be forfeited or delinquency penalties incurred.

---

6. What risk would be involved with a secured loan?

In default, the lender could claim title to the collateral.

---

7. When a business chooses to raise equity capital, the risk is assumed largely by the (BUSINESS/INVESTOR).

INVESTOR

---

8. How could excessive reliance upon trade credit as a capital source restrict the flexibility of a business?

Reliance upon suppliers who agree to extended terms might prevent it from seeking competitive sources of supply.

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9. How could the conditions of a loan agreement adversely affect the flexibility of the owners?

The conditions might prevent them from seeking other debts, incurring certain costs, or taking advantage of expansion opportunities.

---

10. Which of the following capital sources is normally associated with loss of control?

    a. trade credit
    b. borrowed capital
    c. equity capital

---

c. equity capital

---

11. Even when all four factors of risk, cost, flexibility, and control appear to favor one capital alternative, what other factor may be overriding in reaching a decision?

---

availability

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12. Whenever capital is needed, all five evaluation factors should be given equal weight in reaching a decision. (TRUE/FALSE)

FALSE (In a given case, any one factor could override the other four.)

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GENERATING CAPITAL INTERNALLY

Prime Internal Sources

The three primary sources of internal capital are the following:

- Increasing retained earnings through profit improvement and reduction or elimination of the earnings distributions to owners through dividends or drawings.
- Prudent asset management including the disposal of non-productive assets and close control over receivables, inventories, and fixed assets.
- Cost control, taking advantage of the most favorable prices available from suppliers and eliminating all unnecessary elements of cost.

Cost of Internal Sources

A business can take advantage of internal capital sources without necessarily incurring any additional cost. However, there can be cases where additional costs are incurred. For example, fixed assets may be sold at a loss; customers may be lost through the establishment of overly rigorous credit controls; inventory reductions could cause the business to be out of stock on items needed immediately for sales or production; or the sale of certain fixed assets could force the business to resort to uneconomical alternate sources of supply.

As a general rule, a business that retains all, or most, of its earnings so that the business can grow and prosper will benefit from this decision. However, this policy could adversely affect any business that is also forced to seek equity capital from outside investors. The only available sources of equity capital might be interested in the income potential of dividends and drawings as well as potential capital gains. Such investors could easily be discouraged by a policy of retaining all earnings rather than distributing some portion to owners.

Flexibility

In general, the business would incur no loss of flexibility through internal generation of capital.

Control

Since no outside parties are involved when capital is generated internally, the present owners would retain all control over the conduct of the affairs of the business.

Availability

In many cases, the availability of capital from internal sources can be sharply limited. Retained earnings can be increased no faster than profit is realized, even if all income is retained in the business. Capital generation from the disposal of nonproductive assets might not produce significant amounts, particularly if prudent policies and procedures have historically minimized the accumulation of nonproductive assets.

First Source

In general, businesses should utilize all internal sources of capital that can readily be made available without the danger of lost sales revenue or forced recourse to other, more costly capital sources. Even if the amount of capital that can be generated internally is insufficient to meet the entire need, the need can be reduced through the internal sources. As a result, the company's exposure to the disadvantages of other capital sources is reduced. At the same time, the business will build the confidence of potential lenders and investors who may be more willing to risk their own capital in a business that has proven it can manage its own internal affairs.

* * * * *

1. The first source of internal capital is increasing _____ earnings.

---

retained

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2. Retained earnings are increased by improving the profitability of the business and by reduction or elimination of _____ and _____ paid to owners.

---

dividends
drawings

---

3. A second source of internal capital is through prudent _____ management.

---

asset

---

4. A third source of internal capital is through close _____ control.

---

cost

---

5. There is no cost associated with internal generation of capital. (TRUE/FALSE)

FALSE

---

6. How could a rigorously enforced policy of credit extensions involve a cost to the business?

Controls could cause the loss of certain customers.

---

7. How could the disposal of fixed assets involve a cost to the business?

Fixed assets may be sold at a loss or the business might incur unnecessarily expensive alternatives to ownership.

---

8. Flexibility and control are generally unaffected by internal generation of capital. (TRUE/FALSE)

TRUE

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* * * * *

TRADE CREDIT

Accessibility

Trade credit is often the most easily accessible external capital source for small businesses. Unlike debt and equity, it seldom involves complex and often time-consuming negotiations. An intelligent approach to the utilization of trade credit can help the business meet short-term needs with few complications.

Cost

The cost of trade credit can often be quite high, depending upon the normal trade terms available from suppliers in the industry. For example, assume that a company purchases from suppliers who offer terms of a 2% cash discount within 10 days and a net date of 30 days. By forfeiting the cash discount of 2%, the business realizes use of its money for an additional 20 days at a cost of 2%. On an annualized basis, this is equivalent to a 36% interest rate! Similarly, late payment or delinquency penalties can often prove costly. These usually run about 1% to 1½% monthly. On an annualized basis, this is equivalent to 12% (1% per month) or 18% (1½% per month).

Risk

Excessive reliance upon trade credit as a capital source can invite risk. For example, suppliers might refuse to deliver or might put the company on a C.O.D. basis at a time when a cash shortage could make it unable to accept delivery if an immediate cash payment is required.

Flexibility

Even with a planned approach to maximizing available trade credit, a business may find itself heavily committed to those suppliers who accept extended payment terms. As a result, the business may no longer have ready access to other, more competitive suppliers who might offer lower prices, a superior product, or more reliable deliveries.

Control

In general, the owners of a business would suffer no loss of control through the full utilization of available trade credit. Loss of control could only occur if trade credit were overextended to a point where suppliers take legal

action, attaching property owned by the business or forcing the business into receivership.

Availability

The availability of trade credit is somewhat limited. Even the most liberal suppliers will seldom be receptive to terms that involve payment in more than 60 to 90 days.

Best Use

Trade credit is best used as a source of capital to meet relatively small, short-term needs. Effective use of trade credit requires intelligent planning to avoid unnecessary costs through forfeiture of cash discounts or the incurrence of delinquency penalties.

Every business should take full advantage of trade credit that is available without additional cost in order to reduce its need for capital from other sources.

* * * * *

1. The forfeiture of a 2% cash discount in order to retain the use of your cash for an additional 20 days is equivalent to a _____% annual interest rate.

36% (360 ÷ 20 = 18; 18 x 2% = 36%)

---

2. Payment of a 1% monthly delinquency penalty is equivalent to a _____% annual rate.

12% (12 x 1%)

---

3. The cost of forfeiting cash discounts is relatively (HIGH/LOW) compared with most borrowing.

HIGH

---

4. What risk could a company invite through excessive reliance upon trade credit?

Suppliers could refuse delivery or put the company on a C.O.D. basis.

---

5. How could a business lose flexibility through excessive reliance upon trade credit?

It may be sharply restricted in its ability to locate competitive suppliers who will accept extended payment terms.

---

6. The owners of a business could lose control if trade creditors took legal action. (TRUE/FALSE)

TRUE

---

7. The availability of trade credit to meet capital needs is (LIMITED/UNLIMITED).

LIMITED

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8. How is trade credit best used as a capital source?

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Through intelligent planning to meet relatively small, short-term needs without incurring the cost of cash discount forfeitures or delinquency penalties.

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* * * * *

AVAILABILITY

Availability of Debt

Debt capital may not be available for any of several reasons. Some of these are subjective judgments on the part of the lender. The lender may have doubts about the business; the future of its product, service, or market; or the managerial skill of its owners and officers.

Money Supply

While the business may be able to present arguments that counter these objections, reasons beyond their control may make debt capital unavailable to them. The "money market" may be tight. The banking community's supply of funds available for commercial loans may be low. Those funds that are available will be lent to borrowers of long-standing and proven capability with whom the bank has sustained a continuing, profitable relationship at little or no risk.

Financial Condition

Finally, and often most important, the lender may feel that the business' financial condition is not strong enough to carry additional debt. In this respect, lenders often apply specific tests to determine whether or not the business has sufficient stability and liquidity to carry the proposed debt burden.

Stability

Stability is the capacity of the business to withstand periods of losses or low earnings without the threat of default on debt repayment obligations.

Liquidity

Liquidity is a measure of the company's ability to meet its current obligations. It is tested by comparing the cash and other assets that should soon be converted to cash (such as receivables and inventories) with its short-term demands for cash.

* * * * *

1. Doubts about the business, its future, or the managerial skills of its owners are examples of _____ judgments by lenders that can limit the availability of debt.

---

subjective

---

2. In a "tight money market," the supply of funds available for loans to small businesses is (LOW/HIGH).

LOW

---

3. When money is in short supply, bankers are more likely to make loans to:

   a. established businesses with a long history of success
   b. small, unproven businesses

---

a. established businesses with a long history of success

---

4. Two factors that a lender ordinarily evaluates when considering a loan request are the _____ and _____ of the business.

---

stability
liquidity

---

5. The capacity of a business to withstand periods of losses or low earnings is called (STABILITY/LIQUIDITY).

STABILITY

---

6. The ability of a business to meet its current obligations is called _____ .

---

liquidity

---

7. Which of the following assets would be the most important measure of liquidity?

   a. cash
   b. real estate
   c. machinery and equipment

---

a. cash

---

* * * * *

Measuring Stability

The stability of a business' capital structure is also an indicator of its ability to carry more debt. If it is already so debt-heavy that a lender would question its stability, the addition of more debt would make a bad situation even worse.

The ability to carry debt can be expressed statistically through ratios. Lenders, particularly banks, frequently rely upon these ratios as guidelines to judge the feasibility of loaning money which would increase a business' debt burden.

Debt-Equity Ratio

One common measure of stability is the "debt to equity ratio," which is calculated as follows:

Debt-Equity Ratio = Total Liabilities ÷ Total Equity

For example, a business has total liabilities of $75,000 and total net worth (equity) of $100,000. Its debt-equity ratio would be calculated as follows:

Debt-Equity Ratio = Total Liabilities ÷ Total Equity

Debt-Equity Ratio = $75,000 ÷ $100,000

Debt-Equity Ratio = 0.75

Comparisons

The lender's judgment as to whether this ratio is low, reasonable, or excessive would depend largely upon a comparison with industry averages. A debt-equity ratio that is perfectly acceptable for a wholesaler may be excessive for a small manufacturer. If the business' debt-equity ratio is above the industry average, most prospective lenders would encourage the company to secure additional equity capital so that its capacity to carry added debt would be increased.

For example, assume that a company had $100,000 in net worth and $200,000 in total liabilities. Its debt-equity ratio would be calculated as follows:

Debt-Equity Ratio = Total Liabilities ÷ Total Equity

Debt-Equity Ratio = $200,000 ÷ $100,000

Debt-Equity Ratio = 2.0

If the industry average is 2.0, the potential lender might feel that the current position is relatively stable but that the addition of more debt would increase this ratio to an unacceptable level. If the business assumed $50,000 in debt, its total liabilities would then be $250,000 and its debt-equity ratio would be calculated as follows:

Debt-Equity Ratio = Total Liabilities ÷ Total Equity

Debt-Equity Ratio = $250,000 ÷ $100,000

Debt-Equity Ratio = 2.50

Debt Capacity

The debt-equity ratio can also be used to estimate the amount of debt that the business can carry based upon its equity. This is estimated as follows:

Debt Capacity = Acceptable Debt-Equity Ratio x Equity

For example, consider a company with equity of $100,000. In its industry, a debt-equity ratio of 1.5 is considered acceptable. Its debt capacity would be estimated as follows:

Debt Capacity = Acceptable Debt-Equity Ratio x Equity

Debt Capacity = 1.5 x $100,000

Debt Capacity = $150,000

If the company's liabilities were already $150,000, a lender would hesitate to lend additional funds. If they were only $125,000, the lender might agree to a loan of $25,000, raising total debt to the full capacity of $150,000.

Guidelines

Ratios are only guidelines. They are not absolutes. The application of ratios to financial decisions must often be tempered by consideration of collateral, local conditions, temporary economic situations, asset turnover, confidence in the owners of a business, and the like.

Acceptable debt-equity ratios vary widely among industries. Economically stable industries with relatively high investments in fixed assets generally have relatively high debt-equity ratios. Industries with relatively low fixed asset requirements that are highly susceptible to economic fluctuations generally have lower debt-equity ratios.

* * * * *

1. The financial stability of a business can be expressed in terms of its _____ ratio.

---

debt-equity

---

2. How do you calculate the debt-equity ratio?

Divide total liabilities by total equity (net worth).

---

3. A business has liabilities of $70,000 and equity of $100,000. Its debt-equity ratio is _____.

0.70 ($70,000 ÷ $100,000)

---

4. A stable capital situation is indicated by a relatively (HIGH/LOW) debt-equity ratio.

LOW

---

5. To calculate a business' debt capacity, you multiply the acceptable debt-equity ratio by the:

   a. present debt
   b. proposed debt
   c. equity

---

c. equity

---

6. A business has equity of $100,000. An acceptable debt-equity ratio for its industry is 1.50. Estimate its debt capacity. $_____

$150,000 ($100,000 x 1.50)

---

7. If the business' total liabilities were $150,000, it could probably carry an additional $_____ in debt.

---

0 ($150,000 - $150,000)

---

8. If its equity increased to $120,000, its estimated debt capacity would increase to $_____, based upon an acceptable debt-equity ratio of 1.50.

$180,000 ($120,000 x 1.50)

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9. Since its total liabilities are $150,000, it could then carry approximately $_____ in added debt.

$30,000 ($180,000 - $150,000)

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* * * * *

Measuring Liquidity

The debt-equity ratio is a measure of stability. However, it does not provide any indication of the business' liquidity, its ability to meet short-term obligations.

Even financially stable businesses can have liquidity problems. This usually occurs when commitments to fixed assets, inventories, or miscellaneous assets tie up the business' capital so that it is not available to meet short-term needs.

Measures of liquidity compare current assets with current liabilities.

Current Assets

Current assets are cash and any other assets that will be converted to cash within the coming year. They normally include accounts receivable, inventories, and any marketable securities owned by the business.

Current Liabilities

Current liabilities are those obligations that must be paid within the coming year. These obligations normally include amounts owed to trade creditors, employees, tax authorities, banks for loan interest, loan principal repayments due within 12 months, and any short-term debt.

Relationship

Since current assets represent the cash that will be available to the business within the year and current liabilities represent the cash that will be needed, the relationship between

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the two is an indicator of liquidity. This relationship gives the potential lender a quick indication of the company's ability to meet its obligations in the forthcoming months.

Working Capital

The first common measure of a business' liquidity is its working capital. Working capital is the excess of current assets over current liabilities and is calculated as follows:

Working Capital = Current Assets - Current Liabilities

If a business had $50,000 in current assets and $25,000 in current liabilities, its working capital would be calculated as follows:

Working Capital = Current Assets - Current Liabilities

Working Capital = $50,000 - $25,000

Working Capital = $25,000

Current Ratio

Working capital measures the dollar difference between current assets and current liabilities. A second indicator, the current ratio, expresses the current assets as a multiple of current liabilities. For example, a current ratio of 2.0 means that the business has $2.00 in current assets for every $1.00 in current liabilities. The current ratio is calculated as follows:

Current Ratio = Current Assets ÷ Current Liabilities

If a company has $50,000 in current assets and $25,000 in current liabilities, its current ratio would be calculated as follows:

Current Ratio = Current Assets ÷ Current Liabilities

Current Ratio = $50,000 ÷ $25,000

Current Ratio = 2.0

* * * * *

1. The ability of a business to meet its short-term obligations is called _____ .

---

liquidity

---

2. The debt-equity ratio is a measure of (STABILITY/LIQUIDITY).

STABILITY

---

3. If a business' stability is adequate, as determined by its debt-equity ratio, its liquidity must also be satisfactory. (TRUE/FALSE)

FALSE

---

4. Which of the following could cause a stable business to have a liquidity problem?

   a. excessive fixed assets
   b. excessive inventories
   c. either of the above

---

c. either of the above

---

5. Cash and those assets that will probably be converted to cash within one year are called _____ assets.

---

current

---

6. Which of the following are current assets?

   a. cash
   b. plant and equipment
   c. accounts receivable
   d. inventories

---

   a. cash
   c. accounts receivable
   d. inventories

---

7. Obligations that must be paid within one year are called _____ liabilities.

---

   current

---

8. Which of the following are current liabilities?

   a. taxes owed on the previous year's income
   b. amounts earned by employees but not yet paid
   c. any portion of a long-term debt that is due within one year

---

   All three answers are correct.

---

9. The relationship between current assets and current liabilities is an indicator of (LIQUIDITY/STABILITY).

   LIQUIDITY

---

10. The difference between current assets and current liabilities is called:

    a. working capital
    b. the current ratio
    c. net worth

---

    a. working capital

---

11. To calculate working capital, you subtract _____ from _____ .

---

    current liabilities
    current assets

---

12. A business has $60,000 in current assets and $20,000 in current liabilities. Its working capital is $_____ .

    $40,000 ($60,000 - $20,000)

---

13. The current ratio is a measure of (LIQUIDITY/STABILITY).

    LIQUIDITY

---

14. How do you calculate the current ratio?

    Divide current assets by current liabilities.

---

15. A company has current assets of $75,000 and current liabilities of $25,000. Its current ratio is _____.

3.0 ($75,000 ÷ $25,000)

---

* * * * *

Acid Test Ratio

A third indicator of liquidity, which more specifically describes the adequacy of the business' short-term cash position, is called the acid test ratio.

To calculate the acid test ratio, you first determine the "quick" assets, those that will probably be converted to cash within 30 days. Ordinarily, this would include only cash and receivables. If a business also has marketable securities, their value should be added.

The acid test ratio is then calculated as follows:

Acid Test Ratio = Quick Assets ÷ Current Liabilities

For example, if a company had cash of $30,000 and receivables of $50,000, its quick assets would be $80,000 ($30,000 + $50,000). With current liabilities of $40,000, its acid test ratio would then be calculated as follows:

Acid Test Ratio = Quick Assets ÷ Current Liabilities

Acid Test Ratio = ($30,000 + $50,000) ÷ $40,000

Acid Test Ratio = $80,000 ÷ $40,000

Acid Test Ratio = 2.0

* * * * *

1. Besides the current ratio, the _____ ratio can be used to measure the liquidity of a business.

---

acid test

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2. To calculate the acid test ratio, you divide _____ by current liabilities.

---

quick assets

---

3. In most cases, quick assets are _____ and _____.

---

cash
receivables
(In some cases, the value of any marketable securities should be added.)

---

4. A company has $20,000 in cash, $50,000 in receivables, and $100,000 in current liabilities. Its acid test ratio is _____.

0.70 ($20,000 + $50,000 = $70,000; $70,000 ÷ $100,000 = 0.70)

---

5. The acceptable acid test ratio is the same in all industries. (TRUE/FALSE)

FALSE

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* * * * *

Long- vs. Short-Term Debt

The debt-equity ratio, which measures stability, makes no distinction between short- and long-term debt. However, indicators of liquidity are sharply influenced by short- and long-term debt. Current liabilities include only debt that must be repaid within one year, not debt due at later dates.

Therefore, liquidity tests can often indicate whether a business should seek short- or long-term debt. With a short-

term loan, the entire amount would be a current liability and would ordinarily reduce the current ratio. With a long-term loan, only the portion due in the first year would be considered a current liability and the current ratio would normally improve.

Consider a business with current assets of $100,000 and current liabilities of $50,000. Its current ratio is 2.0 ($100,000 ÷ $50,000).

If it borrowed $50,000 on a short-term note, its current assets would increase to $150,000 and its current liabilities would increase to $100,000. Its current ratio would then be calculated as follows:

Current Ratio = Current Assets ÷ Current Liabilities

Current Ratio = $150,000 ÷ $100,000

Current Ratio = 1.50

Before the loan, the current ratio was 2.00. However, if the business borrowed $50,000 on a five-year loan payable in five equal annual installments, only the first year's principal repayment of $10,000 would be added to its current liabilities. Current assets would then be $150,000 ($100,000 + $50,000) and current liabilities would be $60,000 ($50,000 + $10,000). Its current ratio would then be calculated as follows:

Current Ratio = Current Assets ÷ Current Liabilities

Current Ratio = $150,000 ÷ $60,000

Current Ratio = 2.50

Therefore, the addition of long-term debt has raised the current ratio from 2.00 to 2.50, indicating an improvement in the business' liquidity.

* * * * *

1. A short-term loan increases:

    a. current assets only
    b. current liabilities only
    c. both current assets and current liabilities

---

    c. both current assets and current liabilities

---

2. With a short-term loan, the increase in current assets is:

   a. greater than the increase in current liabilities
   b. equal to the increase in current liabilities
   c. less than the increase in current liabilities

---

   b. equal to the increase in current liabilities

---

3. A short-term loan has no effect on working capital. (TRUE/FALSE)

   TRUE (Both current assets and current liabilities increase by the same amount. Therefore, the difference between them remains unchanged.)

---

4. A long-term loan will increase both current assets and current liabilities by the same amount. (TRUE/FALSE)

   FALSE

---

5. With a long-term loan, current assets will increase by the amount borrowed. Current liabilities will increase by:

   a. the amount borrowed
   b. the amount of principal that must be repaid within one year

---

   b. The amount of principal that must be repaid within one year

---

6. A long-term loan will (INCREASE/DECREASE) working capital.

INCREASE

---

7. A business has current assets of $100,000 and current liabilities of $50,000. Its current ratio is _____.

2.00 ($100,000 ÷ $50,000)

---

8. The business borrows $50,000 on a short-term loan. This increases current assets to $150,000 and current liabilities to $100,000. The current ratio (INCREASES/DECREASES) to _____.

DECREASES
1.50 ($150,000 ÷ $100,000)

---

9. Ordinarily, a company that receives a short-term loan will immediately (INCREASE/DECREASE) its current ratio.

DECREASE

---

10. Ordinarily, a company that receives a long-term loan will immediately (INCREASE/DECREASE) its current ratio.

INCREASE

---

* * * * *

Collateral

Frequently, the availability of a loan will depend upon the collateral that the business can pledge as security for the amount borrowed. The lender, in valuing the collateral, will be concerned not only with the amount of collateral, but also the quality. Assigned receivables will be judged upon the following:

- Aging
- Credit-worthiness of customers
- Bad debts experience

Inventories will be judged upon the following:

- Current market value
- Sales history
- Turnover

Loans secured by fixed assets, such as real estate and equipment, will be based upon the business' ability to repay, the current market value of the assets if the business defaults on the loan, and the ease with which the lender could dispose of the assets.

Summary

Most small businesses prefer borrowing to meet their needs for external financing. Ordinarily, debt financing is most attractive to the business when considering the effects of cost, risk, flexibility, and control. Debt financing is also easily accessible and involves less administrative effort and expense than equity financing.

However, debt financing is often not available because of lenders' subjective doubts about the business, its lack of stability or liquidity as indicated by ratio tests, or its lack of collateral. When debt capital is unavailable, the business must turn to equity investors, or a combination of debt and equity, to meet its needs for additional capital.

Leverage, or Trading on Equity

The lower cost of debt capital is the basis of a business financing technique called "leveraging the investment" or "trading on equity." In effect, the business borrows at a low rate of interest and invests the proceeds at a higher rate of return.

Consider the case of two identical apartment buildings called Bedrock and Swampside Heights. Each was purchased for $500,000 and each has the same monthly rents. The only difference is that Bedrock is debt-free, while Swampside Heights has a $400,000 mortgage at 9%. The owners of Bedrock have a 100% equity investment, while the owners of Swampside Heights put up only $100,000, 20% of the purchase price. Operating expenses (maintenance, utilities, advertising, depreciation, and property taxes) for each building are $75,000. At annual rentals of $125,000, the condensed income statements for both properties would appear as below:

	SWAMPSIDE HEIGHTS	BEDROCK
Revenues	$125,000	$125,000
less: Operating Expenses	- 75,000	- 75,000
Earnings Before Interest and Income Taxes	$ 50,000	$ 50,000
less: Interest	- 36,000	-
Earnings Before Income Taxes	$ 14,000	$ 50,000

While Swampside Heights' income is much lower, the owners' equity investment was only $100,000. Therefore, the return on the owners' equity would be calculated as follows:

Earnings ÷ Equity = Return on Equity
$14,000 ÷ $100,000 = 14%

For Bedrock, with an equity investment of $500,000 and no debt, the return on the owners' equity would be calculated as follows:

Earnings ÷ Equity = Return on Equity
$50,000 ÷ $500,000 = 10%

At this point, Swampside Heights appears to be well ahead. In fact, if they had $500,000 to invest originally, instead of just $100,000, they might have bought five buildings, not just one. With five buildings, they might have earned $70,000, well more than the $50,000 that Bedrock earned on the same investment!

Capital Gains

When Bedrock and Swampside Heights are eventually sold, the advantages of Swampside Heights' financing become even more dramatic. If each building sells for $750,000, the capital gain would be calculated as follows:

	SWAMPSIDE HEIGHTS	BEDROCK
Sales Price	$750,000	$750,000
less: Mortgage Payout	- 400,000	-
Proceeds from Sale	$350,000	$750,000
less: Equity Investment	- 100,000	- 500,000
Capital Gain	$250,000	$250,000

Swampside Heights' capital gain is 250% ($250,000 ÷ $100,000) while Bedrock's is only 50% ($250,000 ÷ $500,000). Swampside Heights certainly appears far ahead. This approach has been the foundation of many business success stories.

This same approach has also been the cause of many failures. If the local economy suffered or a glut of other buildings caused revenues of both buildings to fall by 20%, from $125,000 to $100,000, the condensed income statements would then look like this:

	SWAMPSIDE HEIGHTS	BEDROCK
Revenues	$100,000	$100,000
less: Operating Expenses	- 75,000	- 75,000
Earnings Before Interest and Income Taxes	$ 25,000	$ 25,000
less: Interest	- 36,000	-
Earnings Before Income Taxes	($ 11,000)	$ 25,000

Swampside Heights is now losing 11% of its equity investment annually while Bedrock is still earning 5% ($25,000 ÷ $500,000) on its investment. Further revenue declines make the comparison even worse. At $75,000, Swampside Heights would lose $36,000 per year while Bedrock would still break even. This is not a desirable situation, but it is one that would permit them to stay in business until the local economy picks up or the demand for apartments in the area is more in line with the supply.

Leveraging is a way of supplementing equity capital with debt. As business improves, it permits dramatic returns. However, as business declines, it can cause rapid failure.

* * * * *

1. How do you calculate return on equity?

Divide earnings by owners' equity.

---

2. A business has net income of $24,000 per year. The owners' equity is $120,000. Its return on equity would be _____%.

20% ($24,000 ÷ $120,000)

---

3. The practice of supplementing equity capital with debt is called _____, or trading on equity.

---

leveraging

---

4. Which of the businesses, Bedrock or Swampside Heights, is more stable?

Bedrock

---

5. Which business would probably be more vulnerable to a recession?

   a. one with a high percentage of debt in its capital structure

   b. one with a low percentage of debt in its capital structure

---

   a. one with a high percentage of debt in its capital structure

---

* * * * *

DEBT VS. EQUITY CAPITAL

Sources for Major Requirements

Despite the advantages of full utilization of internal capital sources and trade credit, major capital requirements ordinarily force businesses to borrow or locate equity investors to realize the capital they need.

Cost of Debt Capital

To determine the cost of debt capital, consider the case of a company that borrows at 10%. It is paying $10 interest for each $100 borrowed. However, the $10 interest expense is deductible in determining the income tax liability. At an effective tax rate of 25%, the amount of net income sacrificed to pay the interest would be calculated as follows:

Interest Before Taxes	$10.00
less: Tax Deduction	- 2.50
Net Cost	$ 7.50

Since each $100 borrowed reduces net income by $7.50, the effective interest cost is 7.5%.

The cost of debt capital is calculated according to the following formula:

Cost of Debt = Interest Rate x (1.00 - Effective Income Tax Rate)

For example, you would calculate the cost of a 12% loan as follows, assuming an effective interest rate of 25%:

Cost of Debt = Interest Rate x (1.00 - Effective Income Tax Rate)

Cost of Debt = .12 x (1.00 - 0.25)

Cost of Debt = .12 x (0.75)

Cost of Debt = .09, or 9%

Cost of Equity Capital

Earlier, you saw that the cost of capital is based upon the cost to the present owners. Debt financing does not change the ownership structure. Therefore, the cost to the business is the cost to the present owners.

Equity financing gives the new owners a portion of the business' earnings. Therefore, the cost of equity capital is usually determined by dividing the portion of expected earnings that will accrue to the new owner(s) by the amount that they pay for their interest.

For example, a partnership sells a 25% interest for $10,000. If the partnership's expected earnings are $12,000, the new owner's participation would be $3,000 ($12,000 x 0.25). Therefore, the cost would be calculated as follows:

Cost = Earnings Participation ÷ Investment

Cost = $3,000 ÷ $10,000

Cost = 0.30, or 30%

For a corporation, the cost is calculated by dividing the expected earnings per share by the selling price of each new share. For example, a business sells stock for $20.00 per share. It expects to earn $4.00 per share. The cost would be calculated as follows:

Cost = Earnings per Share ÷ Selling Price

Cost = $4.00 ÷ $20.00

Cost = 0.20, or 20%

* * * * *

1. A company borrows at 12%. Its effective income tax rate is 25%. Therefore, for every $12 in interest paid, net income after taxes would decline by $_____.

$9 ($12 x 0.25 = $3; $12 - $3 = $9)

---

2. In the previous example, the company's cost of borrowed capital would be:

   a. 6%
   b. 9%
   c. 12%

---

b. 9%

---

3. A company with an effective tax rate of 25% borrows at a rate of 14%. Its cost of debt capital would be _____%.

10.5% [.14 x (1.00 - 0.25) = .1050, or 10.5%]

---

4. In calculating the cost of equity capital, you consider the cost to:

   a. the present owners
   b. the new owners
   c. all owners

---

a. the present owners

---

5. To calculate the cost of equity capital, you divide the participation of the new owners in expected earnings by the amount:

   a. of total earnings
   b. of the new owners' investment

---

b. of the new owners' investment

---

6. An investor pays $10,000 for a 10% interest in a partnership. If the partnership expects to earn $25,000 next year, the investor's participation in earnings would be $_____.

$2,500 ($25,000 x .10)

---

7. You would calculate the cost of the equity by dividing the new investor's participation in _____ by the amount _____.

---

expected earnings
invested

---

8. With an investment of $10,000 and a $2,500 participation in earnings, the cost of equity capital for the partnership is _____%.

25% ($2,500 ÷ $10,000)

---

9. To determine the cost of equity capital in a corporation, you divide the price per share issued into the:

   a. income tax rate
   b. interest rate
   c. expected earnings per share

---

c. expected earnings per share

---

10. A company issues stock at $25.00 per share. Its expected earnings per share are $2.50. Its cost of equity capital would be _____%.

10% ($2.50 ÷ $25.00)

---

* * * * *

Cost Comparison

The cost of equity capital is almost always higher than the cost of borrowed capital. The equity investor is exposed to far more risks than the lender and, to justify this risk, expects a substantially higher return. The risks assumed by the equity investor can be summarized briefly as follows:

- Interest paid by lenders is deducted from operating income before determining the earnings available for equity investors.
- The business is legally obligated to repay amounts borrowed. There is no such obligation with respect to equity investment.
- Unlike many lenders, the equity investor does not have the protection of collateral. If the business should fail, the equity investor would have no claim against any specific assets of the business, nor against the personal assets of other owners.
- If the business should fail, the legitimate claims of all creditors, including lenders, must be satisfied in full before any proceeds are available to equity investors.

The equity investor is an owner of the business, sharing all the risks and, hopefully, the rewards that all owners anticipate. If the business succeeds, the equity investor prospers. If the business fails, the equity investment fails with it. In return for the added risks of equity investment, the investor expects to reap much higher rewards than the relatively secure lender. The result is a substantial increase in the cost of equity capital to the business.

Risk Comparison

Equity capital involves no risk to the business. All of the risk lies with the investors.

By contrast, the risks involved with debt capital are substantial. Interest and repayment obligations could fall due at times that are inconvenient for the business, forcing default on the note. Depending upon the conditions stated in the note agreement, this could give the lenders immediate ownership of collateral, drive the business into bankruptcy, or give the creditors ownership of the business. If the owners personally guaranteed the original note, the creditors would also have access to the personal assets of the owners.

Frequently, businesses attempt to refinance these obligations if they are unable to meet them when due. If all other indicators of the business' success are favorable, such as sales and net income, refinancing is often possible. However, the terms on which refinancing is available will invariably be more costly and more restrictive than the terms of the original note.

Flexibility Comparison

In general, securing needed capital from equity investors would have no negative impact on the business' flexibility in conducting its operations.

However, debt financing can often sharply restrict the business' flexibility in pursuing other financing or expansion opportunities. In some cases, specific provisions of the original agreement may prevent the business from securing additional debt, incurring expenses beyond a limit established by the lender, or investing in certain assets.

Even in those cases where no specific provisions of the note restrict the company's flexibility, the presence of substantial debt obligations will often discourage other creditors or lenders from providing extra financing that the business might sorely need.

Control Comparison

Equity investors are owners of the business and are therefore ordinarily entitled to a voice in the conduct of the business' affairs. The extent of their control would depend upon the number of shares held in a corporation or the percentage interest specified in a partnership agreement.

Lenders do not normally participate in the affairs of the business. In some cases, lenders may require some limited voice in the business' affairs such as representation on the board of directors or the option to approve officers' compensation.

* * * * *

1. Ordinarily, the cost of equity capital is (HIGHER/LOWER) than the cost of debt capital.

HIGHER

---

2. Equity investors seek a higher return on their capital because of the greater _____ that they assume.

---

risks

---

3. A business has a legal obligation to repay the capital of equity investors. (TRUE/FALSE)

FALSE

---

4. The equity investor is protected by collateral. (TRUE/FALSE)

FALSE

---

5. If the business should fail, the first to share in the proceeds would be the (LENDER/EQUITY INVESTOR).

LENDER

---

6. To the business, the element of risk is greater with (EQUITY/DEBT) capital.

DEBT

---

7. The specific actions that lenders can take if the business is in default are normally dependent upon the provisions stated in the note _____ .

---

agreement

---

8. If the owners personally guaranteed the note, the lenders would have a claim against:

   a. collateral only
   b. the assets of the business only
   c. the personal assets of the owners as well as the assets of the business

---

   c. the personal assets of the owners as well as the assets of the business

---

9. A note agreement could restrict the business from seeking additional borrowings. (TRUE/FALSE)

   TRUE

---

10. If a business is unable to make payment on a note, the note can always be refinanced. (TRUE/FALSE)

   FALSE

---

11. When available, refinancing is usually on terms that are (MORE/LESS) satisfactory to the business than the original note agreement.

   LESS

---

12. From a standpoint of flexibility, the more favorable form of financing is (DEBT/EQUITY).

EQUITY

---

13. Lenders may impose restrictions in the note agreement that can prevent the company from borrowing additional capital. (TRUE/FALSE)

TRUE

---

14. From a standpoint of control, the more favorable financing alternative is usually (DEBT/EQUITY).

DEBT

---

15. Equity investors are entitled to a voice in the affairs of the business. (TRUE/FALSE)

TRUE

---

16. Lenders have a legal right to a voice in the affairs of the business. (TRUE/FALSE)

FALSE (only if specified in the agreement)

---

17. On the list below, identify the preferred financing source, debt or equity, for each of the evaluation factors shown.

1. Cost: _____
2. Risk: _____
3. Flexibility: _____
4. Control: _____

---

1. Cost: Debt
2. Risk: Equity
3. Flexibility: Equity
4. Control: Debt

---

* * * * *

Deadlock

Two votes for debt. Two votes for equity. However, as was maintained earlier, not all four factors are equally important. In fact, when things are going <u>well</u> the problems of risk and flexibility are not always important. Therefore, most small businesses are inclined to seek debt capital to meet their major financing needs.

Besides the sharply lower cost, borrowing is often more convenient than raising equity capital. A potential lender is no further away than your nearest commercial bank. On the other hand, the nearest equity investor may be hard to find.

Money can be borrowed on relatively short notice with a minimum of legal and accounting costs. Equity capital exposes the small business to a host of legal intricacies and audit requirements that may prove to be cumbersome, time-consuming, and expensive.

Why Not Always Borrow?

At this point, you could conclude that borrowing is the only answer. Confident of your business' future and its ability to repay its obligations, why worry about risks and flexibility? Why not settle for the lower cost and easier accessibility of the lender rather than pursue the more elusive and expensive equity investor? The answer lies in availability, a subject that will be explained in detail in the next chapter.

COMBINING CAPITAL SOURCES

No Single Source Always Best

Each of the capital sources discussed in this module offers certain advantages and disadvantages. No single source is best for all situations. In any given situation, the owners must evaluate those factors of cost, risk, flexibility, control, and availability that will determine the source, or sources, best suited to their needs.

Combination

Frequently, a combination will present the best solution. When a total need has been established, the amount that must be generated from lenders or equity investors can be reduced sharply through internal sources and trade credit. As a result, the owners can minimize exposure to the negative factors associated with borrowed capital or increased equity investment while inspiring the confidence of lenders and investors.

Typical Combination Program

A typical combination of capital sources for a small business might be as follows:

- Utilizing available internal sources through maximum retention of earnings, prudent asset management, and conscientious cost control.

- Taking full advantage of available trade credit without incurring unnecessary costs through forfeiture of cash discounts or delinquency penalties.

- Utilizing short-term debt capital to meet short-term needs, avoiding the higher interest expense and more restrictive conditions of longer term borrowing. The availability of short-term debt is likely to be increased substantially if the business has quality collateral as security for the loan.

- Combining debt and equity as needed to meet the longer term capital requirements of the business.

Debt-Equity Combinations

As you saw earlier, the ability of the business to secure debt capital will often depend upon the amount of equity in the business. A business with insufficient equity to permit

borrowing needed capital can often resort to a combination since increasing its equity will also increase its debt capacity. For example, a business with $50,000 in debt and $50,000 in equity wants to borrow $40,000. A lender feels that an acceptable debt-equity ratio for the business is 1.00. Consider the effect of the additional $40,000 debt on the business' debt-equity ratio.

Debt-Equity Ratio = Total Debt ÷ Total Liabilities

Debt-Equity Ratio = $90,000 ÷ $50,000

Debt-Equity Ratio = 1.80

Addition of $40,000 in debt would increase the business' debt-equity ratio to 1.80, far above the acceptable 1.00 ratio. However, if the business chose to raise $20,000 in equity capital, its debt capacity would be calculated as follows:

Debt Capacity = Acceptable Debt-Equity Ratio x Equity

Debt Capacity = 1.00 x $70,000

Debt Capacity = $70,000

With its debt capacity now increased to $70,000, the business could probably borrow an additional $20,000 ($70,000 debt capacity - $50,000 present debt).

The combination of $20,000 equity and $20,000 debt would give the company the additional $40,000 that it needs.

Short- vs. Long-Term Debt

Frequently, a company must decide whether its borrowing needs are best met through short- or long-term debt. The availability of short- or long-term debt may often depend upon analysis of the current ratio of the business before and after the proposed loan. For example, a business may have $70,000 in current assets and $35,000 in current liabilities. Its current ratio would then be calculated as follows:

Current Ratio = Current Assets ÷ Current Liabilities

Current Ratio = $70,000 ÷ $35,000

Current Ratio = 2.00

If the owners want to borrow $20,000 in short-term debt and a current ratio of 2.00 is considered acceptable for the industry, the additional $20,000 would lower the current ratio to an unacceptable level. Current assets would increase by $20,000 to $90,000. Current liabilities would increase from $35,000 to $55,000. The current ratio would then be calculated as follows:

Current Ratio = Current Assets ÷ Current Liabilities

Current Ratio = $90,000 ÷ $55,000

Current Ratio = 1.64, an unacceptably low level

However, if the company chose to borrow $10,000 in short-term debt and $10,000 in long-term debt, its current assets would increase from $70,000 to $90,000. However, current liabilities would only increase from $35,000 to $45,000. Therefore, its current ratio would be calculated as follows:

Current Ratio = Current Assets ÷ Current Liabilities

Current Ratio = $90,000 ÷ $45,000

Current Ratio = 2.00

Since this level is acceptable, the company could meet its needs through an additional $20,000 in long-term debt. Only $10,000 would be due in the current year and therefore be considered a current liability.

* * * * *

1. The best source for meeting a business' major capital needs is usually:

   a. internal
   b. trade credit
   c. debt
   d. a combination of sources

---

   d. a combination of sources

---

2. Before seeking external capital sources, a business should:

   a. take full advantage of internal sources
   b. ignore internal sources

---

   a. take full advantage of internal sources

---

3. A business has $40,000 in debt and $40,000 in equity. Its debt-equity ratio is _____.

   1.00

---

4. If 1.00 is considered the maximum acceptable debt-equity ratio for the industry, the business would have to meet its major capital needs exclusively through equity financing. (TRUE/FALSE)

   FALSE

---

5. What alternative to equity financing would be available?

   A combination of debt and equity.

---

6. Increasing the equity of a business tends to (INCREASE/DECREASE) its debt capacity, based upon the debt-equity ratio.

   INCREASE

---

7. If a business has $40,000 equity and an acceptable debt-equity ratio of 1.00, its debt capacity is $_____.

$40,000 ($40,000 x 1.00)

---

8. When a business' current debt capacity is fully absorbed, it can expect to increase its debt capacity only by increasing its _____.

---

equity

---

9. An equity increase of $10,000 would increase debt capacity by $_____, if an acceptable debt-equity ratio were 1.00.

$10,000 ($10,000 x 1.00)

---

10. The capacity of a business to incur additional short-term debt could be based upon analysis of its current ratio. (TRUE/FALSE)

TRUE

---

11. If a business has $80,000 in current assets and $40,000 in current liabilities, its current ratio is _____.

2.00 ($80,000 ÷ $40,000)

---

12. If the business borrowed $10,000 on a short-term note, its current assets would increase to $_____ and its current liabilities would increase to $_____.

$90,000 ($80,000 + $10,000)
$50,000 ($40,000 + $10,000)

---

13. Its current ratio would then be _____.

1.80 ($90,000 ÷ $50,000)

---

14. However, if the business borrowed $20,000 on a long-term note, with $10,000 due in the first year and the balance due at some later date, its current assets would increase from $80,000 to $_____ and its current liabilities would increase from $40,000 to $_____.

$100,000 ($80,000 + $20,000)
$50,000 ($40,000 + $10,000)

---

15. Its current ratio would then be _____.

2.00 ($100,000 ÷ $50,000)

---

* * * * *

APPROACHING LENDERS AND INVESTORS

Communication

Small business owners have often been frustrated in their attempts to borrow from commercial banks or to secure capital from equity investors. Frequently, the basic problem is one of communication. The small business owner, enthusiastic about the future of the business, does not understand why the banker or investor fails to share the enthusiasm.

Facts and Figures

The banker or investor, accustomed to dealing in facts and figures, does not understand how a business owner could approach them in search of capital without a well-developed plan that they can use as a basis for making their decision.

Bridging the Gap

The small business owner is in a position to bridge this gap by preparing a plan that will help the banker or investor make an analytic judgment about the future of the business and its worthiness as a credit risk or attractive investment.

Plan Elements

The basic elements of such a plan should consist of the following:

- Forecast of Capital Requirements. This forecast should state not only the amount of capital needed, but also the reasons for the need. It should detail such factors as amounts needed for fixed assets; the amount needed for receivables or inventories and how these amounts were determined; how much cash will be generated from operations; how the owner plans to use internal financing sources; and when the capital will be needed.

- A Profit Plan. This should project sales and profit for a period at least equal to the term of any loan. In the case of an equity investment, a minimum period is five years. The profit plan should detail sales revenue, cost of sales, and expenses so that the banker or investor can make comparisons with other businesses in the same industry to determine whether or not the projections are realistic.

- A Marketing Plan. This plan specifies how the business intends to achieve its sales projections, describing specific marketing steps such as the addition of new locations, new products, or new services; increases in the sales force; an advertising budget; and promotional efforts.

- A Cash Flow Statement. This statement should indicate how much cash will be available from operations and how it will be used to acquire assets, reduce liabilities, compensate investors, and the like. The cash flow statement permits the banker to determine how the loan will be repaid and the equity investor to determine the compensation that can be expected from the investment.

Building Confidence

The analysis, effort, and logic that go into the formation of such a plan will not only make it easier for bankers or investors to evaluate your business, but will also enhance their confidence in your business and your skill as a manager.

SUMMARY

Avoid Many Problems

The selection of the proper source to meet a particular capital need can free you of many headaches, avoid unnecessary costs, reduce the possibility of debt repayments which cannot be met, avoid curtailment of credit from suppliers, maintain inventory needed for sales needs, and minimize possible loss of control to equity investors.

Presenting Your Case

In particular, it is important that you, as a small business owner, know how to present the best case for your business to potential lenders or equity investors. In effect, you must sell these people on the merits of your business and your own management skills. To do this effectively, you must know what they are thinking, how they will evaluate your business, and how they will appraise you as a competent, skillful manager.

Human Factors

Lenders and investors are human. After analysis of all the facts, their decision will often rest upon their subjective judgment about the capability of the person who is managing their money. By applying the knowledge you have derived in this booklet to your requests for capital, you will be able to present an intelligent case that will represent your business and yourself in the best possible light.

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